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Foreign Economic Trends and Their Implications for the United States

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HONDURAS

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KEY ECONOMIC INDICATORS
(In millions of U.S. Dollars unless noted)

	1985	1986	1987	1988p
Economic Growth				
Population (millions)	4.4	4.5	4.6	4.8
Population growth (%)	3.1	3.1	3.1	3.1
GDP in current dollars	3489	3800	4055	4400
Per capita GDP, current dollars	798	843	874	917
GDP on constant 1978 prices	2154	2213	2329	2421
Real GDP growth (%)	3.2	2.8	4.2	4.0
Money and Prices				
Money supply growth (%)	1.4	8.6	17.9	11.7
Interest rate (%)	16.3	16.1	15.5	17.0
Savings Rate (% of GDP)	11.0	8.0	6.8	7.7
CPI (% change)	3.4	4.4	2.5	4.5
Official exchange rate	2.00	2.00	2.00	2.00
Parallel exchange rate (End of year)	2.20	2.45	2.65	3.00
Government Finance				
Central government budget				
Current revenues	546	591	664	714
Current expenditures	618	679	761	818
Capital expenditures	256	166	144	159
Balance	-326	-276	-272	-313
Government Deficit as % of GDP	9.1	7.3	6.7	7.1
Public Sector Debt				
Domestic Debt	913	1014	1171	1475
External Debt	2234	2352	2404	2508
Debt-Service Ratio as % of exports	26.0	30.9	31.5	38.9
Balance of Payments				
Exports of goods and services	918	1022	982	1029
Imports of goods and services	1268	1328	1338	1393
Transfers	145	158	131	135
Current Account balance	-205	-147	-225	-229
Capital account: net inflows	290	193	215	133
Exports to the U.S. (FOB)	367	404	446	449
Imports from the U.S. (C.I.F.)	318	332	351	360
U.S. economic assistance	156	178	159	163
U.S. military assistance	67	61	61	41

p = preliminary

SUMMARY

Continuing a modest recovery from the severe economic recession of 1981-1983, the Central Bank reported that the Honduran economy grew 4 percent in real terms in 1988. This was the second year in a row that real income per capita increased and was primarily due to improved prices for the country's chief exports (bananas), inflows of external economic assistance (largely from the United States), and the accumulation of external debt-service arrears. The value of Honduras' exports grew 7.5 percent, while imports increased 3.8 percent. However, the current account balance remained negative, and Honduras suffered a deterioration in the capital account. As a result, the Honduran currency weakened in the parallel exchange market from 2.50 lempiras per dollar at the beginning of 1988 to a low of 3.50 in November. The official exchange rate remained fixed at 2 lempiras per dollar.

The Government of Honduras (GOH) reported an inflation rate of 4.5 percent in 1988, up from 2.5 percent in 1987. This inflation rate was based on an inappropriate market basket giving heavy weight to basic commodities subject to price controls. A middle class market basket would have produced an inflation rate in the 10 to 15 percent range, but even this was still one of the lowest in the hemisphere. Despite this relatively favorable outcome in 1988, the Honduran economy faces a severe financial crisis caused by large fiscal and balance-of-payments deficits, and distortions created by an overvalued currency.

In September 1988, Honduras successfully concluded negotiations with the World Bank on a $50 million structural adjustment loan (SAL). At a World Bank-led Consultative Group meeting held in October in Paris, donors pledged to improve coordination. Negotiations continued during the rest of the year with the International Monetary Fund (IMF) and the Japanese Government for a standby program and a SAL cofinancing loan, respectively. Negotiations also continued in 1988 with the commercial banks on restructuring official debt, but these finally collapsed in early 1989 when the bank advisory committee was formally abolished. As of mid-June 1989, the GOH had not been able to reach an agreement with the IMF and the World Bank. If Honduras does not take needed macroeconomic adjustment measures well before presidential elections to be held in late November, the lempira will undergo tremendous pressure, and the economy will face a serious disruption of major proportions, leaving and almost insuperable financial crisis confronting the new president in early 1990.

PART A - CURRENT ECONOMIC SITUATION AND TRENDS

ECONOMIC GROWTH

Honduras has recorded modest but positive real growth since 1985, when it began to recover from the deep economic recession of the early 1980s. According to the Central Bank, the economy grew 4 percent in real terms during 1988, down from 4.2 percent in 1987. The economic expansion was led by growth in public administration and defense (7 percent), mining (6.7 percent), and manufacturing (4.9 percent). Agriculture and agribusiness, the largest and most important sector representing about 25 percent of GDP, grew only 2.5 percent in real terms due to low productivity, low prices, and unfavorable weather conditions.

The Honduran economy faces a serious financial crisis due to large fiscal and balance-of-payments deficits and to a mounting debt service burden. The balance-of-payments situation worsened considerably in 1988, with sharp deterioration in the capital account. Facing mounting pressures from its external creditors during 1989, Honduras is finding it increasingly difficult to obtain even short-term financing to cover its current account deficits. Unless the Government of Honduras reaches agreement with the IMF and other creditors by mid-1989, the prospects for positive per capita real growth in 1989 appear doubtful.

EXTERNAL TRADE

In 1988, the Honduran Government reported an increase in exports of 7.5 percent and imports of 3.8 percent. Seafood experienced the largest growth, primarily due to the rapid development of the cultivated shrimp industry. The export value of bananas, the country's leading export, increased 10.4 percent due to improved prices. The value of coffee (the second most important export) fell 7.3 percent due to decreased production resulting from heavy rains. Exports of minerals, (chiefly led, zinc, and silver) increased sharply, owing to the reopening of the El Mochito mine. Other traditional exports, lumber, beef, sugar, tobacco, and cotton, stagnated or declined during 1988.

Honduras' best potential for future growth lies in its nontraditional exports, including apparel, palm oil, fruits (especially citrus and melons), and vegetables. Nontraditional exports increased 15 percent in 1988, but over the last four years have grown at only an 8 percent annual rate. This slow growth is due to the economic disincentives to invest, resulting from daunting bureaucratic and legal barriers in addition to the overvalued exchange rate.

EMPLOYMENT, WAGES, PRICES, AND ORGANIZED LABOR

The Honduran Government officially estimates unemployment at 12 percent of the work force, but underemployment is much higher,probably affecting as much as 30 percent of the work force.

The minimum wage, which has not been raised since 1981, is 5 to 7 lempiras per day (equivalent to $2.50 to $3.50). It is expected that the minimum wage will be raised this year as a result of strong lobbying efforts by organized labor during an election year. Although the Central Bank reported that the inflation rate for 1988 was only 4.5 percent, this figure is based on an inappropriate market basket that gives disproportionate weight to basic commodities whose prices are controlled. A middle-class CPI would have shown an inflation rate of 10 to 15 percent. As a result, real wages continued to decline during 1988, and the number of strikes increased during the year. Strikes at the end of 1988 by public employees and by banana workers resulted in government concessions to increase wages and benefits. The Honduran Congress agreed to pay the lost wages of the banana workers, perhaps encouraging future strikes. This trend towards congressional involvement in labor has continued into 1989. The increase in the minimum wage, coupled with a probable chain reaction fueling price and general wage rises, will exacerbate the fiscal deficit.

Hondurans are protected by a progressive labor code that is closely adhered to by the GOH. Approximately 20 percent of the labor force is unionized. There are three major labor considerations, of which one is Marxist. Marxist unions exist in several of the autonomous state agencies such as the water and electric power companies, but these unions control only a few private company unions. Under an informal agreement with the Free Zone located in Puerto Cortes, labor provides a one-year grace period to new investors. Since the Free Zone was established in 1978, only one day of work has been lost to a strike. Of the 11 major strikes in 1988, only two directly affected private industry. Most of the strikes were called by public employees, teachers, and hospital workers. Labor did threaten to call for nationwide solidarity strikes on several occasions but was unable to garner much support. Organized labor has expressed strong opposition to management-employee associations (Solidarity Organizations). Nevertheless, the number of Honduran members of such associations has increased in the last year from 2,000 to 10,000.

FISCAL POLICY

According to preliminary Central Bank data, government revenues increased 6.7 percent in 1988, due primarily to improved tax collection and the effects of inflation. Current expenditures increased 6.4 percent. Nevertheless, because of large transfers to state enterprises, the operational (nonfinancial) fiscal deficit of the Central Government increased to 7.1 percent of GDP, compared with 6.7 percent in 1987. The Honduran Government turned increasingly to internal financing of the fiscal deficit during 1988, resulting in more crowding out of the private sector from the credit markets. The GOH also increased its use of overdrafts ("sobregiros") to finance expenditures in excess of budgeted amounts. Overdrafts reached 600 million lempiras by the end of 1988. Although the Honduran Congress restricted the use of overdrafts in December 1988, large extra-budgetary expenditures will likely continued in 1989.

Salaries account for 51 percent of current government expenditures. Since the GOH is unwilling to reduce the number of public employees, efforts to restrain expenditures have been frustrated by the political power of the unions to obtain wage and benefits increases. Capital expenditures remained at the same level of 1987, but public investment has fallen off considerably from previous years due to the completion of the El Cajon hydroelectric project. Government expenditures for debt service increased 38 percent in 1988 due to higher interest rates and the effects of the weaker dollar.

MONETARY POLICY

In 1988, as in prior years, the GOH attempted to compensate for its large fiscal deficits and overvalued currency by tightening monetary policy. The Central Bank increased the commercial banks' reserve requirement form 32 percent of assets to 35 percent in March 1988, resulting in a squeeze on liquidity, particularly to the private sector. Interest rates for borrowers rose to the ceiling level of 17 percent. Central Bank credit to the government, however, increased sharply in order to finance the large fiscal deficit. This resulted in severe crowding out of the private sector. The tightened lending policy extended to the rediscount lines of credit administered by the Central Bank. The money supply (M1) grew 11.2 percent in 1988, down from the 17.9 surge registered in 1987. Even tighter monetary control will be required to counter the mounting pressure on the lempira.

Unless measures are taken to reduce government spending, the private sector in Honduras will suffer continued crowding out which will reduce private investment. At the same time, Honduras' relatively underdeveloped banking system, faced with an interest rate ceiling and the high reserve requirement that increases the cost of making loans, is unable to offer higher interest rates to savers. This has tended to keep Honduras' savings rate dismally low, has helped stimulate capital outflow, and has restricted new private investment.

EXCHANGE RATE POLICY

Honduras has maintained a fixed official exchange rate of 2 lempiras to the dollar since 1918. Price levels in Honduras are higher than in neighboring countries, triggering massive inflow of contraband consumer goods that compete with domestically produced goods. Due to the increasing overvaluation of the lempira, a black market developed during the early 1980s. In an effort to provide a stimulus to exports, the Honduran Government initiated the CETRA (Transferable Export Certificate) program in early 1988. Exporters are issued CETRA certificates equivalent to a certain percentage of their export revenues. The certificates represent claims on foreign exchange which may be used by the exporter to finance his own import requirement or to sell to third parties through the commercial banks at a freely determined market rate. By the end of 1988, the system was expanded to 40 percent to the value of all export products (except coffee, lumber, beef, sugar, and cotton, which receive 20 percent). This measure expanded the share of foreign trade financed

outside of the official exchange rate to about 50 percent of the total. Reflecting the increasing scarcity of foreign exchange, the parallel market rate weakened from 2.50 lempiras per dollar at the beginning of 1988 to a low of 3.50 lempiras per dollar in November. The GOH reacted by delaying authorization of import permits in December, and the parallel rate subsequently strengthened to 3 lempiras per dollar. By mid-June 1989, the lempira had fallen again to 3.40.

DEBT MANAGEMENT POLICIES

At the end of 1988, Honduras' external public debt reached $2.51 billion, equivalent to 57 percent of GDP. A large proportion of this debt is to international financial institutions. Honduras' debt-service ratio has increased from 26 percent in 1985 to 38.9 percent in 1988 because of the depreciation of the dollar against other currencies as well as the expiration of grace periods on large loans to finance the massive El Cajon hydroelectric project. Honduras' balance-of-payments difficulties has caused the GOH to accumulate arrears in excess of $100 million to official creditors alone. In January 1989, the Honduran Government began a more confrontational approach to debt-service payments. During January-March 1989, Honduras paid only $5.3 million in official debt service while an additional $67.6 million matured. This is the fastest rate of arrears accumulation in Honduran history.

Honduras has not made principal payments on its debt to foreign commercial banks since 1983. After protracted negotiations, the Honduran Government and the bank advisory committee reached a tentative agreement during 1988 on a comprehensive debt rescheduling package on the outstanding balance of $207 million in principal and $31 million in past due interest. That agreement was never signed because of Honduras' inability to obtain sufficient foreign exchange to pay past due interest. In February 1989, the bank advisory committee was disbanded, and the commercial banks separately began seeking ways to reduce their holdings of Honduran paper.

In December 1988, the Honduran Congress approved a debt-to-equity conversion law which will facilitate the sale of the commercial debt and encourage investment in Honduras. The Honduran Government approved three debt conversions worth $16.5 million during 1987 and 1988 before the law was passed. Debt-to-equity conversion applications must be filed with the Ministry of Finance. A mixed public-private sector commission will approve the projects eligible for debt conversion and will negotiate with the investor on the terms of local currency bonds issued to finance the swap. The investor must sell these bonds in the secondary market in order to obtain the lempiras for his investment. There are currently 27 project applications under the new debt conversion law for a potential new investment of $90 million. Specific project reviews by the commission await the issuance of implementing regulations being prepared by the Ministry of Finance.

STRUCTURAL ADJUSTMENT POLICIES

Much of Honduras' serious fiscal deficit problems stem from a bloated and inefficient public sector. Reducing government expenditures by cutting the public payroll is highly politically explosive due to the power of the state enterprises and public employees unions. As a result, the Azcona Administration has little success in rationalizing the operations of the central government or the state enterprises. In 1987, the GOH began a promising program of privatizing certain companies held by the state development corporation, CONADI, and the state forestry company, COHDEFOR. To date, eight state-owned companies have been privatized. The Ministry of Natural Resources' seed industry and agricultural mechanization program have also been partially privatized. An additional four privatizations are scheduled to take place in 1989, including three hotels and a tomato paste processing plant.

FOREIGN ECONOMIC ASSISTANCE

Honduras relies heavily on foreign economic assistance to finance its balance-of-payments and fiscal deficits. The United States is by far the single largest bilateral donor. Total disbursements of U.S. economic aid increased to $167.4 million in 1988, up from $153.7 million in 1987. Of the total, $130.1 million was provided in the form of grants (including $90 million in Economic Support Funds, ESF), and $37.3 million in the form of highly concessional loans. In addition, Honduras received $15.6 million in PL-480 loans and grants. The largest Peace Corps contingent in the world assists Honduras with development projects at the microeconomic level in such areas as rural health and education, "micro-enterprise" development, and environmental protection. In 1989, Honduras will receive about $163.7 million in direct economic assistance from the United States, including $80 million in ESF, $62.1 million in development assistance, and $21.6 million in PL-480 loans and grants.

PART B - IMPLICATIONS FOR THE UNITED STATES

The United States continues to be Honduras' most important trading partner. In 1988, the United States purchased over 50 percent of Honduras' exports and supplied 39 percent of its imports. U.S. companies account for about 90 percent of direct foreign investment in Honduras with an estimated value of $250 million. The largest U.S. investments are in fruit production (particularly bananas), oil refining and marketing, and mining. In addition, U.S. corporations have invested in tobacco, beef, poultry, and animal feed production, shrimp cultivation, insurance, leasing, food processing, brewing, and furniture manufacturing. Leading U.S. exports to Honduras include machinery, agricultural chemicals, fertilizer, and basic grains.

The 1928 United States-Honduras Treaty of Friendship, Commerce and Consular Rights provides for most-favored-nation treatment for investors of either country. The United States and Honduras also signed an Agreement for the Guarantee of Private Investments in 1955 and an Agreement of Investment Guarantees in 1966.

The U.S. Overseas Private Investment Corporation (OPIC) has provided various types of investment insurance and financing in Honduras since 1955. OPIC currently insures eight U.S. investments in Honduras against currency inconvertibility, expropriation, and war risks for a total of $32 million in coverage. OPIC currently has additional application for insurance coverage pending, representing potential new investment of $60 million. Since 1980, OPIC has provided $9.7 million in financing both in direct lending and in loan guarantees to U.S. investors in Honduras. In 1988 alone, OPIC disbursed $6.2 million in new financing to U.S. investors in the country. Since 1955, OPIC has never had to pay a claim under its insurance programs. However, beginning in 1988 firms have experienced increasing difficulties in obtaining dollars through the banking system to service OPIC loans.

Honduran imports will be constrained in 1989 by a severe shortage of dollars at the official exchange rate and the difficulty in obtaining financing, as well as by reduced spending by the GOH on public investment projects. However, the inability of the country to produce many of the raw materials, parts, equipment, and other products necessary to keep the economy operating, in addition to the traditional reliance on U.S. suppliers, will tend to maintain the U.S. market share at recent levels. Since U.S. ESF assistance must be used to purchase an equivalent amount of imports from the United States, this requirement will also help sustain the level of U.S. exports to Honduras.

Because negotiations with the commercial banks collapsed in early 1989 and GOH arrears to official creditors have built up to over $160 million, international commercial financing for Honduran imports will be reduced during the reminder of the year. Banking lines of credit have been reduced or eliminated with U.S. correspondent banks due to difficulties in repayment. Eximbank's short-term lines of credit guarantees and FCIA and USAID's joint Trade Credit Insurance Program (TCIP) were closed in 1987 due to payment arrears in both programs, although the Central Bank is attempting to resolve the problem so that both credit lines may be reinstated.

As a beneficiary of the Caribbean Basin Initiative (CBI) and the Generalized System of Preferences (GSP), Honduras exports to the United States enjoy duty-free treatment for most products. These programs provide a stimulus for the development of nontraditional exports in the region. The Honduran private sector investment promotion foundation (FIDE) opened two offices in the United States in 1988. FIDE plans to open a new office in Hong Kong during 1989, oriented toward promotion of apparel assembly investment by Asian companies seeking access to the U.S. market from a CBI country.

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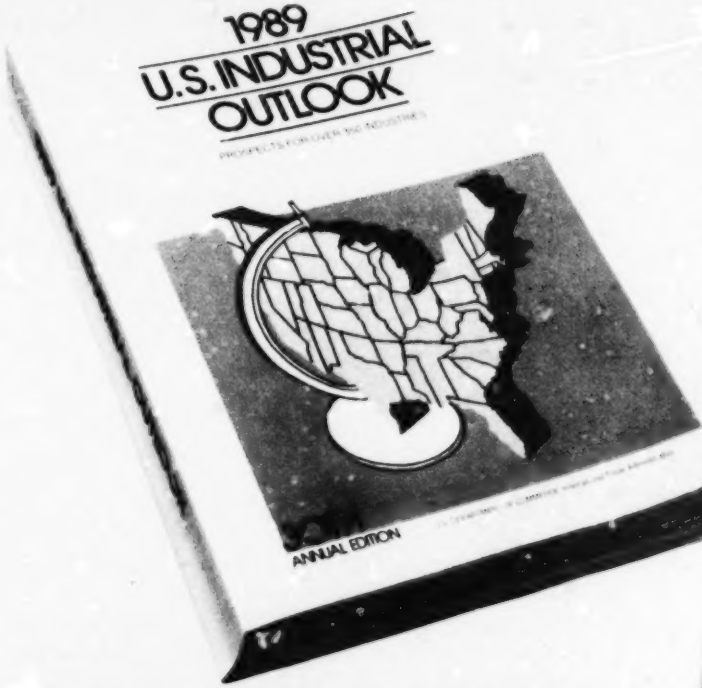

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